

California Fair Political Practices Commission

MEMORANDUM

To: Chairman Randolph and Commissioners Blair, Downey, Karlan and Knox

From: Holly B. Armstrong, Commission Counsel
John W. Wallace, Assistant General Counsel
Luisa Menchaca, General Counsel

Re: Pre-Notice of Regulation 18728.5 and Amendments to Regulation 18703.3 –
Definition and Reporting of Incentive Compensation

Date: August 18, 2003

Introduction and Background

The Political Reform Act (“Act”) requires that the assets and income of public officials which may be materially affected by their official actions be fully disclosed, and in appropriate circumstances, the officials should be disqualified from acting in order that conflicts of interest may be avoided. (Govt. Code Section 81002(c)¹.) “Public officials, whether elected or appointed, should perform their duties in an impartial manner, free from bias caused by their own financial interests or the financial interests of persons who have supported them.” (Section 81001(b).)

In *In re Hanko*, O-02-088 (August 9, 2002),² the Commission ratified existing advice that incentive compensation received by a board member of a hospital district, Terilyn Hanko, was attributable to the purchaser of her employer’s products, as well as her employer, as a source of the income for disqualification purposes. The Commission expressly did not decide the impact of the opinion on the disclosure requirements of section 87207, but directed staff to investigate whether a regulation regarding the reporting of incentive compensation was necessary.

In *In re Hanko*, the Commission was presented with a situation in which the member of the hospital board also worked as a marketing representative for a pharmaceutical company, Baxter Pharmaceuticals. As part of her employment, she made marketing presentations to doctors and nurses regarding introductions to and follow-up utilization of various pharmaceutical products made by her employer. In addition to the salary she received from her employer, Ms. Hanko also received a bonus payment based on overall sales of her employer’s products within Ms. Hanko’s territory, calculated using a rather complicated formula, but based entirely on product gross sales performance within the representative’s territory.

¹ All further statutory references are to the Government Code unless otherwise specified.

² Commission opinions are available on the Commission’s website at www.fppc.ca.gov through the “Library and Publications” link at the top of the page.

The hospital board on which Ms. Hanco sat was in the process of negotiating a multi-million dollar lease with a hospital with which Baxter, through Ms. Hanco, did business. Ms. Hanco was able to determine that approximately \$1,000 of her incentive compensation for the year 2000 was attributable to purchases by the hospital of Baxter products. The Commission determined that this extra compensation was “incentive compensation” and that the hospital was a source of the incentive compensation to Ms. Hanco for disqualification purposes.

The hospital board appealed the Commission’s decision by filing a Petition for Writ of Mandate in the Sacramento Superior Court. In *Peninsula Health Care District v. Fair Political Practices Commission*, Sacramento County Superior Court Action No. 02CS01766, (March 3, 2003), after the court affirmed the Commission’s opinion, stating:

“[T]he court notes that respondent’s opinion is not only within the scope of the law, it is also reasonable as a matter of fact. Ms. Hanco undeniably was able to identify and quantify a portion of her income that was specifically attributable to MPHS purchases of products from her employer. The fact that the money she earned in incentive compensation was actually paid to her by her employer, and not by MPHS, is, as respondent found, a matter of semantics rather than reality. Moreover, the possibility that Ms. Hanco might face an issue in her official capacity that would have a material effect on that portion of her income by increasing or decreasing MPHS’ purchasing activity is clearly one of the situations the Political Reform Act was intended to address. Respondent’s application of the law to the unique facts of this case was appropriate and sensible.”
Id. at 13.

As stated above, the issue of disclosure of incentive compensation was not decided in the Opinion, but staff was directed to investigate the necessity of a regulation regarding the reporting of incentive compensation. Staff concluded that it would be appropriate to present for pre-notice discussion regulations that would both define incentive compensation and outline procedures for reporting it.³

The regulations presented with this memorandum are the result of staff’s review of the current procedures for reporting commission income, which might be called the first cousin to

³ Although staff recommends that disclosure of incentive income be required, it should be noted that there have been situations in which the Commission has pierced the first layer to find that a public official had an economic interest in a third party, but did not require disclosure under section 87207. For example in *In re Nord*, (1983) 8 FPPC Ops. 6, the Commission found that a public official who was a limited partner had an economic interest in not only his controlling general partners, but also in “any other business entity in which either Smith or Jones or both act as a controlling general partner or controlling shareholder” Thus, the Commission said, disqualification was required in those cases. However, the Commission did not require that the public official disclose such third parties as economic interests.

incentive compensation⁴, and comments received at the Interested Persons Meeting, held June 24, 2003. The reporting rules for commission income are currently embodied in regulation 18703.3.

Structure of Proposed Regulatory Amendments

Current regulation 18703.3 deals with both disqualification and disclosure requirements for any public official who receives commission income. As such, it includes the only definition of “commission income” found within the regulations. To facilitate the adoption of an incentive compensation disclosure regulation, we propose to extract from regulation 18703.3 that portion of the existing regulation dealing with disclosure, and combining it with the new incentive compensation disclosure provisions to form regulation 18728.5. At the same time, a definition of “incentive compensation” has been added to regulation 18703.3, and regulation 18728.5 cross-references to the definitions of “commission income” and “incentive compensation” in regulation 18703.3.

This accomplishes a couple of things. The disclosure regulations are physically located in a different area of the regulations than the disqualification regulations. Therefore, this restructuring of the regulations will have the effect of keeping the disqualification provisions together and of putting the commission income disclosure provisions with the other disclosure regulations, while also adding the new incentive compensation disclosure provisions.

The specific changes are discussed in more detail below.

Proposed Amendments to Regulation 18703.3

The first proposed change to regulation 18703.3 is in subdivision (a), with the insertion of some clarifying language in the first two sentences. The insertion of the phrase “including commission income and incentive income as defined in this regulation,” in the first sentence simply clarifies that both commission income and incentive compensation fall within the definition of “source of income” in section 87103(c). The change from “the Political Reform Act” to “Government Code sections 87100 and 87103(c),” is simply a clarification of the actual Government Code sections under which promised income is included in an official’s income for disqualification purposes.⁵

⁴ Some of the differences between commission income and incentive compensation include the following: commission income is received in a specific sale or similar transaction, whereas incentive compensation is income received over and above salary, which is ongoing and/or cumulative as sales or purchases of goods or services accumulate; and an official who receives commission income may be self-employed, whereas an official who receives incentive compensation will always be employed by another person. The two are similar in that, for disqualification purposes, the income or compensation is attributed to each source of income or compensation in the transaction, if it reaches the \$500 threshold. (Section 87103(c).)

⁵ A public official may be subject to disqualification based on promised income, but only income actually received is reported. (Sections 82020, 87100, 87103, and 87207.)

The next proposed change is the deletion of subdivision (c)(1), which is an introductory paragraph stating that subsection (c) contains the disclosure and disqualification requirements for officials receiving commission income. This subdivision is no longer necessary because regulation 18703.3 now contains only disqualification requirements, and no longer includes disclosure requirements.⁶

The final proposed change to regulation 18703.3 deals with the addition of subdivision (d), which is the definition of “incentive compensation.”

During deliberations of *In re Hanko* the Commission debated the definition of “incentive compensation” at great length before adopting it for incorporation in the final Opinion, and purposely kept the definition narrow, with an eye toward excluding situations such as the law firm associate who brings a client to the firm and is compensated with a portion of the billings from that client. A review of the minutes of the Commission meeting at which this discussion took place discloses the desire of the Commission that the “incentive compensation” definition be narrow and as precise as possible and include situations that do not constitute “incentive compensation.” (Commission Meeting Minutes, June 7, 2002, pp. 4-8).

“Chairman Getman made a substitute motion asking staff to draft an opinion that would conclude that a conflict exists, but would rely less on whether it is a bonus or a commission, and instead would come up with principles addressing when this type of payment would be a source of income and include clear principles defining when it would not be a source of income.” (Commission Meeting Minutes, June 7, 2002, p. 8).

Therefore, staff has made a conscious effort to draft a definition of “incentive compensation” that very closely tracks the definition in the Opinion and also attempts to specify what is not included in “incentive compensation.”

“Incentive compensation” was described in *In re Hanko*, O-02-088 (Aug. 9, 2002) as:

“an additional sum of money paid over and above a base salary, based solely on results achieved by the individual as a product of his or her efforts, and typically measured against pre-determined goals set by the employer. It differs from ‘commission’ in that it is not based on a specific sale or similar transaction, and differs from a ‘bonus’ in that it is not a singular event, but is ongoing and/or cumulative as sales or purchases accumulate. Thus, the incentive income, like a commission, is ultimately determined based on the

⁶ The next few changes are non-substantive in nature including renumbering and the insertion in new subdivision (c)(1) of the phrase “by a public official.” The deletion of subdivision (c)(5) is done to accommodate moving the commission income disclosure provisions to the new regulation 18728.5.

conduct of the purchaser in direct response to the efforts of the public official. This definition of 'incentive compensation' expressly excludes salary."

The factors that led to payments from Baxter, Ms. Hanco's employer, to Ms. Hanco being attributed to the hospital (MPHS), a purchaser of her employer's products, were that Ms. Hanco:

- "1) has been employed to purposefully direct sales or marketing activity toward the purchaser;
- 2) there is direct contact between Director Hanco and the purchaser intended by Director Hanco to generate sales or business; and
- 3) there is a direct relationship between the purchasing activity of the purchaser and the amount of the incentive compensation received by Director Hanco."

In re Hanco, supra, O-02-088, at pg. 8.

The definition staff proposes to insert at subdivision (d) of regulation 18703.3 is as follows:

"Sources of Incentive Compensation. 'Incentive compensation' means income received by an official who is an employee, over and above salary, which is ongoing and/or cumulative as sales or purchases of goods or services accumulate, and which is calculated by a predetermined formula set by his or her employer and which correlates to the conduct of the purchaser in direct response to the effort of the official. Incentive compensation does not include: salary; commission income; bonuses, the amount of which are based solely on merit, performance measured against a preset standard or goal, or hours worked over and above a predetermined minimum; and such executive incentive plans as may be based on company performance, but where the formula for determining the amount of the executive's incentive income does not include a correlation between that amount and increased profits derived from increased business with specific and identifiable clients or customers of the company. Incentive compensation also does not include payments for personal services which are not marketing or sales.

"The purchaser is a source of income to the official if:

“(1) The official’s employment responsibilities include directing sales or marketing activity toward the purchaser;

“(2) There is direct contact between the official and the purchaser intended by the official to generate sales or business; and

(3) There is a direct relationship between the purchasing activity of the purchaser and the amount of the incentive compensation received by the official.”

The additional exclusions that do not appear in the original definition are intended to exclude from the definition specific categories of compensation addressed by the Commission during the discussion of the *Hanko* Opinion.

For example, the Commission was concerned that the definition of incentive compensation not encompass bonuses awarded to associates employed by law firms. Such bonuses might be based solely on hours billed over a minimum number, based on a combination of hours billed and new clients the associate brought to the firm, or a variety of other permutations or scenarios.

In addition, executive compensation plans such as might be awarded to top management personnel, which staff, in its research into incentive compensation, discovered are quite common, are also excluded from the definition. These plans typically set a target for incentive compensation based on a percentage of the executive’s base salary and the particular executive’s position within the company. The company’s overall performance, sometimes for one year, sometimes for multiple years with the current year being given greater weight, is then used to evaluate whether and/or how much incentive compensation will be awarded. Because the incentive compensation is based on the company’s overall performance, however, and is not tied to the volume of business from particular clients or companies, this type of incentive compensation does not fall within the definition set forth in the *Hanko* Opinion.

Regulation 18728.5

Regulation 18728.5 is the disclosure or reporting regulation of the commission income/incentive compensation package that we are presenting to the Commission for consideration.

Subdivision (a) incorporates the definitions of “commission income” and “incentive compensation” from regulation 18703.3.

Subdivision (b) incorporates the disclosure requirements that were previously in regulation 18703.3(c)(5). The requirements presented in regulation 18728.5 are the same as those that appeared in regulation 18703.3; however, they have been rewritten so as not to make reference to particular forms to avoid requiring changes to the regulations when changes are made to the forms. Some other changes have been made to wording for purposes of clarification. However, nothing

new has been added to this subdivision, and nothing will change in the way that commission income is reported under the newly numbered regulation.

Subdivision (c) contains the reporting requirements for incentive compensation. In subdivision (c)(1), the requirement is made clear that basically, a public official is required to report separately the name of each person who was a source of incentive compensation, if the public official received incentive compensation of \$500 or more attributable to that source of incentive compensation during the period covered by the statement. This is in addition to reporting the incentive compensation, along with any salary, reimbursement of expenses and other income received from his or her employer. A sample of how incentive compensation would be reported pursuant to this regulation is attached hereto as Exhibit A.

This subdivision also sets forth a basic distinction between the reporting of commission income and incentive compensation. Because a public official who receives commission income on a regular basis is treated as a business entity (reg. 18728.5(b)(1)(A)), individual sources of income are not reported until the amount of commission income provided by the source to the official reaches \$10,000 or more. (Reg. 18728.5(b)(2).) However, because incentive compensation can only be received by an official who is employed by another person, individual sources of income are reported at the level of \$500 or more.

Subdivision (c)(2) also requires an official to perform whatever calculations are necessary to determine the amount of the incentive compensation he or she receives that is attributable to each of his or her clients, in the event his or her employer does not provide that information.

Conclusion

The proposed regulations, a new reporting regulation 18728.5 and amendments to regulation 18703.3, present the most logical and cohesive approach to implementing a reporting regulation for incentive compensation, within the presently-existing scheme.

Staff recommends that regulation 18728.5 and the amendments to 18703.3 be approved for adoption in October, as proposed.